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BANKNOTES AND LENDING POWER

I

In the panic of 1907 it was impressed on the public and on Congress that our monetary system was not of the kind that could successfully withstand the stress of a coming monetary stringency or the greater dangers of a serious financial collapse. These impressions have led to the widespread demand for monetary reform, to the appointment by Congress of the National Monetary Commission, and to the publication by this commission of a great mass of material on money and banking. These volumes may help in the education of Congress, but because of their bulk they are not likely to help very much in the education of the public. It is clear, however, from these volumes and from knowledge previously in our possession that the lessons to be had from other countries as well as from our own country must inevitably be drawn upon in framing the concrete proposals of the commission to Congress. Moreover, under our political methods, it is not a question as to what outside experts may propose but what the leaders in Congress think can be passed through both houses under the present conditions of public opinion (educated, of course, as far as possible). This situation we must keep in mind in all our discussions. The lessons to be got out of these volumes and the inferences from them which are applicable to conditions in the United States can without doubt be very simply presented. If so, and if made intelligible to the general public, there is a good chance that they can be impressed upon Congress and enacted into law.

We must of course beware of the man with a cut-and-dried system, who has a beautiful theory sure to prevent all panics and to cure all the ills of industry. As in the case of any disease, we must first find out what is wrong, and next try to discover a remedy to meet the particular ill. First, then, as to the difficulties disclosed in the past which must be overcome by a correction of our monetary system. Very recently Secretary MacVeagh by his urgent suggestions to the national banks to organize currency associations under the Aldrich-Vreeland Act of March 30, 1908, in order to be prepared for an expansion of banknotes in case of an unexpected emergency, has consciously or unconsciously indicated his belief—so far, of course, as his recommendation may indicate a belief—that monetary and credit emergencies can be met by the issue of banknotes. On the other hand, if his words were correctly reported, the chairman of the National Monetary Commission expressed the belief that the problem was not so much one of circulation as it was one of the organization of credit. The problems, therefore, to my mind, seem to center about banknotes on the one hand, and the power of a bank to lend on the other; (1) the needs of the public for currency and (2) the needs of a bank when under pressure in meeting demands for loans.

II

The needs of the public for currency to act as a medium of exchange in buying and selling goods, in paying wage-rolls, in travel, etc., are obvious. In certain sorts of transactions, mainly in a part of retail trade and in districts unused to banking methods, some form of money must be passed from buyer to seller. In total amounts, however, these transactions are insignificant in comparison with those transactions on a large scale which are carried on by checks, drafts, or bills of exchange—without the use of any forms of ordinary money. With an increasing population, but chiefly with the increasing products bought and sold at retail, the demand for currency, such as it is, must normally increase absolutely in greater or less sums. For such needs an elastic banknote circulation, slowly rising but ex-

panding and contracting sharply with seasonal demands, is imperative. Our present national bank circulation does not provide for this elasticity. It expands and contracts without any direct relation to the demands of the community. To this point of elasticity much emphasis has been directed, and I do not wish to minimize its importance; but it is to be doubted if it is as vital as some suppose. If we used only banknotes (or other paper money) as a medium of exchange the insistence upon an elastic banknote circulation would be of first importance; and in the limited field in which actual money is imperative, the need of an elastic banknote issue to the general public remains highly important. Although we have the deposit currency as a medium of exchange which is perfectly elastic, elasticity of note issues should receive attention in the due proportion of the importance of banknotes to other media of exchange, under normal conditions of business.

Still keeping in mind, however, the needs of the public for a medium of exchange and not the needs of the bank itself, it will probably appear to many that the demand of the public for expanding issues of currency is of vital importance in a time of financial distress, such as that in the autumn of 1907. To those who set most store by the virtues of an elastic banknote issue this seems the crux of the whole matter. It is supposed that in a time of stringency the public will demand more circulation; and to support this view the events of the panic of 1907 have been drawn upon as proof. It is true, of course, that government or banknotes could not be had in most cities during the height of the panic in 1907, even in small sums; and as a consequence the clearing-house associations issued clearing-house notes (as distinct from clearing-house loan certificates) for circulation among the public. Without doubt, this inability to get cash for a small check on a bank or at a paying office made a deeper impression on the minds of the people than any other event during the panic. It was this popular belief in the need of more money to which Congress evidently catered when it passed the Aldrich-Vreeland Act, as a provisional measure before a coming election in 1908. It was, as everyone must admit, a striking

commentary on the inadequacy of our banking and monetary system that it was impossible for the banks to supply to employers of labor and for the small needs of every day a relatively small amount of currency having a general circulation. Yet, on the other hand, it is a fact that the total amounts of the clearing-house notes for the use of the public were not large, nor were they long outstanding. Moreover, as affecting the ability of the producing and trading firms to weather the stress of the panic, they had practically no influence whatever. The banks were more frightened than the public. The demands of the small local banks for additional precautionary reserves drew down the cash reserves of city banks more than did the demands of business men. This was the reason for the scarcity of circulation. The holding on to their cash by city banks was primarily in the interest of reserves and therefore in the interest of those who wished loans or who had to be carried for a time.

The power to expand their note issues (which are liabilities) could not have added to the cash reserves of the banks and thus have enlarged their power to aid needy borrowers. It is true, however, that an expansion of note issues would have aided the banks indirectly; it would have allowed them to satisfy the urgent demand of the public for a medium of exchange by passing out their notes and thus would have enabled them to retain lawful money which could be used as reserves to support their loans and deposits. But, primarily, the issue of banknotes is for circulation in the hands of the public and not for any serious advantage which they render in increasing the power of the bank to lend and to stave off a panic. Accordingly, the prevailing idea that we must provide against future panics and avoid a repetition of what happened in the panic of 1907 by arranging for the rapid issue of banknotes in a time of emergency is quite aside from the real point; for it is based on the wrong assumption that it is the lack of currency in the hands of the public. and not the difficulty of the banks in lending, which is the critical thing at such a time.

This popular insistence on the view that we can prevent the occurrence of panics and meet all the dangers of a financial panic

once it is upon us by the device of an expansion of banknotes is, in my judgment, based on an erroneous analysis of banking operations in times of pressure. Very respectable authorities have asserted that our monetary system is radically at fault so long as it will not prevent the occurrence of panics. And the belief that the Bank of England or the Bank of France—as central institutions—have been able to head off speculation and avert the evils of expanded credit is referred to as an instance of what can be done by a central institution in this country. We have been led to think that the issue of notes is the means by which the effects of the crisis are met and its inconveniences reduced; in the case of England by the suspension of the Bank Act bringing out more notes from the Issue Department; and in the case of France directly by the increase of notes of the Bank of France. As we shall see later this appeal to the banks of England and France is wholly unfounded in fact.

The reserve city bank which can quickly increase its own notes can supply the demands made upon it by country national banks and correspondents—provided the country bank wishes only currency for circulation in its neighborhood and not for its own reserves. Here, again, the new bank issues do not give the pivotal aid which some suppose always comes from additional circulation. Not being lawful money, they could not be used in reserves and therefore would not—and could not—improve the lending power of the local country bank. They would, however, supply currency to the country bank which could be paid out, if urgently demanded, and thus indirectly protect reserves.

Another advantage in emergency banknotes, of course, is the opportunity they present to national banks having relations with state banks and trust companies. By issuing their own notes they may exchange them for lawful money held by banks outside the national system. In this way they can indirectly increase their lawful money and consequently their power to lend.

All the above advantages are patent and are arguments in favor of a margin of elastic note issues. But these issues have only a limited importance and would not cure the fundamental difficulties existing in times of panic. The principal reason for

this statement exists in the fact that, obviously, the bank cannot replenish its reserves—which are an asset—by an addition to its own notes, which are a liability. Apart from its illegality it is a banking lie.

Moreover, the use of its cash resources in the direct purchase of any kind of bonds or securities to be deposited for the protection of its emergency notes would not only not improve but really reduce the power of a bank to lend and thus reduce its ability to aid needy borrowers. A sum of $100,000 in lawful money in the reserves would allow loans and consequent checking accounts of from $400,000 to $600,000 when borrowers are calling for help—provided borrowers used checks as a means of payment. Therefore, a bank would cripple itself should it invest $100,000 of lawful money in securities in order to issue only $100,000 of note issues—thus allowing loans of only the same amount. Consequently, no system of note issues based on the purchase of securities by cash will touch the center of the need.

Finally, too much is made of the need of an elastic bank circulation in a time of panic in view of the fact that we already have a perfectly elastic medium of exchange in our deposit currency, especially for all large transactions. The term "money" is loosely used. We use gold as a standard, but we do not use it to any appreciable extent as a medium of exchange. More than 95 per cent. of our large transactions are performed by a check and deposit currency which rises and falls exactly in proportion to the exchanges of goods which call forth loans and bank deposits. Under existing familiar methods of payment by checks and drafts, the borrower who is able to get a loan in a time of stress has no difficulty whatever in meeting his maturing obligation by a check on a solvent bank. To get the loan is the important thing—not the particular form of liability which the bank gives him on making the discount. In fact, on getting the loan the borrowing merchant would not wish to take out notes and then be obliged to find a place in which to deposit them again. It is clear, therefore, that the mere power to issue banknotes in itself is not the only nor the most important way of meeting an emergency brought on by a disturbance of credit.

We have heard much in this country about the need of an elastic bank currency. About a marginal elasticity to a large total circulation in normal conditions for seasonal demands I have already spoken. There is no difference of opinion concerning that need. But most persons who advocate an elastic currency have in mind a need of a very different kind—the need of help to borrowers in a time of panic. For a need of this kind, careful examination will disclose that the issue of banknotes is of minor importance and does not touch the real cause of difficulty. I say of minor importance; for the ability to pay off depositors in banknotes would undoubtedly give to customers of a bank the means of meeting maturing indebtedness. But the serious pressure comes from those whose deposit accounts are insufficient to meet heavy panic demands; then will the power to issue more notes (a liability) enable a bank to enlarge its loans greatly without having thereby received anything which will increase its cash reserves? That depends entirely on what system of note issues we are going to adopt and whether cash reserves are to be required for the notes as well as for demand deposits. If the latter, the power to issue notes would be of no assistance whatever in making additional loans to hard-pressed borrowers. In fact, in the proposed bill of the American Bankers' Association in 1908, I believe a reserve against notes was required. In short, there is no little confusion of thought as to the thing really needed in a time of panic.

It is a crude thought that an increase of banknotes is needed by the general public as a medium of exchange because of the inability of business men to exchange goods due to a scarcity of currency. The real difficulty resides not with the general public and the media of exchange—for checks are as good as ever as a medium of exchange if there are deposit accounts on which they can be drawn—but with the banks, with the power of the banks to expand their loans in a time of stress. This is the pivotal thing in any plan to relieve the distress of a financial panic (even with those who are urging an elastic currency as a cure-all).

III

So much for the relation of bank issues to the situation created by a financial crisis; but as has been already pointed out there are other elements in the situation of far greater importance. When we look back to the panic of 1907 we find three important happenings, connected in purpose and need, which altogether transcend the minor question of the issue of clearing-house currency for public use. These three points of central importance have to do with the lending power of the banks and are as follows: (1) The importation of gold; (2) The deposit of lawful money with the banks by the Treasury; (3) The issue of clearing-house loan certificates.

Every banker, every borrower, who was concerned with the work of preventing disaster from spreading in 1907 knows how dominating were these three matters. Why? Because they directly touched the power of the banks to lend. There was a crisis, not because of a scarcity of a medium of exchange in the hands of the public, but because the central banks had had excessive demands made upon them for loans and because they held paper which had become more or less unsound. A crisis comes because credit has been unduly expanded in a period of prolonged prosperity; in an optimistic spirit men have entered into transactions beyond their actual means, as is shown when the test of actual payment is exacted; and in a time of fright collateral as well as goods falls in price. In such a situation liquidation needs time if disaster is to be prevented. The banks are called upon to carry houses doing a legitimate business that are in trouble. Just when timid persons or country banks are drawing down cash reserves, the banks are forced by the situation to increase their loans. In the one week ending November 2, 1907, the reserves of the New York banks fell $37,000,000, while loans were increased $60,000,000. That showed that the New York banks met a difficult situation with courage and good judgment. At their own risk they came to the rescue of a hard-pressed business public. Everything centered in those things which would aid the lending power of the banks. It is needless

to say that the issue by the bank of its own liabilities in the form of notes would be an insignificant palliative and would not touch (except as before mentioned) the cash reserves and the power to lend. *The one central thing to be done was to increase reserves.* Here is the crux of the whole matter, whether it is a time of an impending stringency or the storm-center of a crushing panic. The bank's own notes (its own liability) cannot legally or morally be used to fill up its reserves (the bank's active asset). Here is the fatal deficiency of banknote issues as a means of curing a panic. The one thing needed was lawful money which could be used as reserves. We must face facts and not be led away by theories. The New York banks got this lawful money in two ways: (1) by importing gold and (2) by deposits from the Treasury.

1. They imported gold as a means to enable them to aid needy borrowers. They used their resources to buy or borrow over $100,000,000 of gold because it was one of the forms of lawful money by which reserves could be filled up. By anyone who had the means of purchase, gold could be got in a week from Europe. Therefore, gold proved to be the one part of our monetary system—besides checks on deposits—which was perfectly elastic. It could be increased by importation or decreased by exportation at will.

2. But gold was not the only form of lawful money. When banks were being drained of their reserves, the main recourse was to the Treasury of the United States. Unlike banknotes, government deposits directly increased the reserves and increased the lending power of the banks from four to six times the deposits. The Secretary, in leaving the largest sums in banks in New York, the center of the disturbance, gave his aid where it would do the most good. It is obvious that the service rendered by the importation of gold and the deposits of lawful money by the Treasury could not have been accomplished by issues of banknotes.

3. The most important of the devices resorted to in 1907, however, as well as in former panics as far back as 1861, was the issue of clearing-house loan certificates. What was the point of

their issue? It was not that the country needed more money for general circulation or more media of exchange, but that the banks whose reserves had run down needed aid for the purpose of lending to hard-pressed borrowers. In a crisis what is wanted —and wanted above all other things—is the loan. Once given the loan, the borrower has no difficulty in finding a medium of exchange, by which he can transfer his credit in a way to satisfy his maturing obligation. The loan is the primary thing. All that the creditor demands is a means of payment acceptable in his community. It is just at this point that I venture to say we find the most confusion of thinking and the greatest amount of loose talking. It is carelessly assumed that the great need is an issue of banknotes, when in reality the great need is some means —whatever it may be—which will enable a bank to make loans to a client, who can thereby be saved from failure and from hasty and ruinous liquidation. The whole object of clearing-house loan certificates, then, is—not to provide currency—but to make loans possible to legitimate though needy borrowers. After loans are made, checks provide all the means of payment anyone needs. The increase of a bank's liabilities does not increase its reserves or its power to lend; so that the issue of banknotes—except as above indicated—is wholly aside from the point.

IV

One result of the publications of the National Monetary Commission is that we shall hear much about the experience of the great banks in Europe.[1] But deductions from Europe, as has been pointed out by the Chairman of the commission, must be made with caution. In England conditions as to payments by deposit currency are much like our own, but in France very little work is done by checks drawn on deposits and nearly all by the notes of the Bank of France, and much the

[1] In all there are no less than ten volumes issued by the National Monetary Commission on European Banks, amounting to 4,096 octavo pages (of which that on the German Bank Inquiry of 1908 alone contains 1,162 pages) to say nothing of other subjects treated. For students these works are highly useful and convenient.

same is true of Germany. Thus the same general principles of banking would work out in England, France, Germany, and the United States, but through very different instruments.

In England, in a crisis, aid seems on the face of things to be rendered by an increase of the Bank of England notes, when the Bank Act of 1844 is suspended. In fact, as everyone knows, the act has not been suspended since 1866; and even when suspended, very little use of the new notes has been made. Why? The Issue Department is as much separated from the Banking Department as if they were different institutions—although under the same management. The gold and securities behind the notes in the Issue Department are entirely separated from the resources of the Banking Department. Therefore, the latter can use the notes of the Issue Department in its reserves. The whole point of the suspension of the Bank Act lies, then, in the fact that the Banking Department can fill up its reserves by taking securities to the Issue Department and getting notes for them under a temporary suspension of the law. The immediate object is to increase reserves so that loans can be made freely; while the idea of getting out more notes into general circulation, on any theory that the public needs more money, is not at all considered. The mere possibility of a resort to suspension is sufficient to quiet alarm because legitimate borrowers know they can get loans whenever required, and therefore practically no use is ever made of the new notes. Of late years the change in the rate of discount is sufficient to prevent reserves from falling to a point where suspension is ever necessary. Here again in an emergency it is a question of the lending power of the bank and not the need by the public for more banknotes as a medium of exchange.

In France things are otherwise. An increase of loans by the Bank of France is necessarily carried through by an issue of more notes. Within the outside limit set by law, the bank can increase its issues at will. The essential thing, of course, is the ability to get a loan in an emergency; and when that is obtained, as a matter of course the bank supplies the special form of liability which the business public demands—which in France is

not a deposit account but a note issue. Either would serve the same purpose as a means of payment; but that one is taken which custom prescribes—the check in England, the note in France. The fundamental thing is to be found in the power to lend and not in the note issues. And back of that, it is the phenomenally high character of the short-time paper which allows the Bank of France quickly to adjust itself to changed conditions; together with the policy of keeping very high metallic reserves behind the notes—perhaps 85 per cent. They escape panics in France by greater care than is given here in selecting only high-class paper at the Central Bank. Copper speculation, however, can bring disaster to a bank there as well as here. The Bank of France can maintain a low and uniform rate of discount chiefly because it is not a money-making machine and is excessively conservative in the kind of paper it discounts.

V

Working directly from the facts of our own experience and from a reading of the volumes of the National Monetary Commission, we may be permitted a very brief statement of the constructive measures which should be undertaken to prevent the excessive and ruinous results of credit expansions in the future.

1. First of all, emphasis must be placed on the indisputable truth that no monetary legislation can prevent business optimism, over-trading, and the recurrent waves of speculation and liquidation. The control of such movements, which are sure to be pressed upon banks by an eager, money-making public, lies primarily in the hands of the banks. The banks are the servants of their constituencies; as a rule, they do not lead, but follow the demand of their customers; but they must not be willing to follow recklessly. Not infrequently we hear it said that European countries, with large central banks, have a system which prevents panics. The truth is that panics have been largely avoided in the last thirty years in such countries as England, France, and Germany because the management has been cautious and conservative in granting loans. Quite irre-

spective of the differences between the forms of banking organization in the United States and the forms employed in England, France, and Germany, we could as effectively suppress potential panics as they if we were as willing as they to scrutinize loans.

2. In the second place, we must in no way relax our efforts to satisfy the great need of an elastic bank circulation. We need what might be called marginal elasticity—a change of relatively small amounts on the margins of a fairly large normal circulation, dependent for its amount wholly on the demands of trade and not on the fiscal needs of the government. The various bills presented to Congress—chief among which is the bill of the American Bankers' Association—bear on this general point. They are important; but as previously explained they do not provide a remedy for the situation existing in a time of panic. Expansion can go on, and has gone on, through the Banking Department of the Bank of England without the issue of any notes and solely through the creation of deposit accounts as the consequence of expanded loans. Therefore, we must admit the fact that an elastic banknote circulation, while bringing needed reforms, will not accomplish in times of stress what most persons have in mind at the present time when urging a change in our monetary system.

3. Having now disclosed the real need, how can that need be met effectively? In the main, assistance must come in such a way that reserves can be enlarged with safety. Therefore, the emergency issues—if any are allowed—must be in some form of lawful money. How and by whom are they to be issued?

Certainly not by the government. The very first lesson of public finance is to learn to separate the fiscal from the monetary functions of the Treasury. The state must separate its income and expenditures, its borrowings and payments, its fiscal duties, wholly and radically from its control over the monetary standard and the media of exchange. To confuse or to mix these is to invite disaster at the first real crisis. Compare our chaos when we confused these two things on and after February, 1862, when we made the first issue of greenbacks as a loan, with

the stability of the French standard during the enormous expansion of loans in their crisis of 1870–73.

In brief, what is the essence of the remedy? Clearly enough, the lending power of a bank cannot be increased in an emergency by means of an increase in liabilities. It can come only by an operation dealing with its assets and in such a way that a part of the assets—either bankable short-time paper or securities—can be transformed into means of payment which will enlarge the reserves. The whole emphasis should be put upon the matter of reserves. In the past this work has, in fact, been done either by using securities to import gold or to obtain government deposits or by getting clearing-house certificates to the amount of 75 per cent. of the value of chosen commercial assets. Such methods are irregular, voluntary, and clumsy. The underlying principles, however, should be incorporated into practicable simple, legal means open to all, and well understood before any emergency arises.

The issue of clearing-house loan certificates has been, in my judgment, a means of averting untold disaster in many crises; the collateral behind them has been based on the fundamental business of the country and they have always been retired at an early date without the loss of a dollar. Yet it is likely that as a practical device they are somewhat clumsy and possibly exposed to the 10 per cent. tax on state-bank issues. Therefore, they may be only the first step in an evolution to something even more effective but built up on the same lines. It is always wise to allow the remedy to grow out of our past experience rather than to introduce an entirely new scheme to which it may take a long time to get adjusted.

Therefore, the central point of our banking reform, so far as I am able to suggest anything practical, is an organization of national banks, supervised by the government but not under government management, which shall have the power, under regulations securing great care in the selection of collateral, to transform picked assets and securities into forms of money which can be used as lawful reserves—with the usual requirements, by tax or otherwise, for their early withdrawal as soon

as the emergency has passed. This form of money need not appear in general circulation. This, after all, is the essence of the operation in a crisis at the Bank of England—the country whose conditions are most nearly like our own. If we accept these principles and the general purpose, it would not be difficult to draft the law which should contain them.

We ought not to be wedded to names or preconceptions. It is immaterial whether such an organization is called a Central Bank or not. It is material, however, that it should accomplish the purpose of enabling a bank to meet a temporary paroxysm of credit by getting more reserves and by increasing its lending power through the deposit of first-class collateral. My instinct is against any one large, centralized institution the management of which might become an object of attack or a political prize in a campaign. So far as I can now see, it ought to be built up out of the present clearing-house organizations. There should be common action and conference of those who know the conditions of business in all parts of the country; but the actual judgment, when the quality of the paper and securities offered by a bank in order to obtain those reserve notes is to be passed upon, should obviously be given only by those in certain parts of the country who are familiar with persons and trade in the localities where the requests are made. Moreover, the relation of state banks and trust companies to the national banks in the large cities in a time of crisis can be best regulated through organizations like the clearing-house boards. There should be no difficulty whatever in creating local or district clearing-house boards, chosen by the banks themselves—just as clearing-house committees are now chosen—who should pass upon the issues of those reserve notes. These district boards might then be united or represented for common action in a central board, who might have a veto upon the extreme action or the possible unwisdom of any one local board. The scheme has, moreover, the political advantage that it does not propose a money-making institution nor a financial "octopus," but a simple, direct method of enabling the borrowing public to get aid from banks in time of distress.

Were such an organization once put into operation I am firmly convinced that we should henceforth be preserved from the highly terrifying and unnecessary paroxysms of credit which have characterized our past financial history. More than that, we should then come to understand by actual experience—just as in England since 1844—that our expansions of credit and its liquidation may come and go independently of the quantity of banknotes outstanding. Attention will then be taken away from the minor question of the quantity of notes in the hands of the public to the vital question of the character of the credit granted and to the control and vigilance over the kinds of discounts made by a bank. From whatever angle we approach the banking business we are always forced sooner or later to recognize that everything depends upon the quality of the discounts and the kind of assets held as a consequence of making loans. The measures recently put into force by the present Comptroller of the Currency, such as more stringent examinations and the credit bureau, are to be highly praised because they bear directly upon this general principle. It lies at the center of all real insurance or protection to depositors; and it lies at the center of our whole question of banking reform which aims to relieve us of the disasters of sudden and forced liquidation in a time of panic.

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